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FOR PROFIT AND NONPROFIT BUSINESSES - WHAT'S THE DIFFERENCE?

By Steven L.F. Ho

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A. Introduction.

Health and human service providers may be organized as either for profit or nonprofit entities. These materials contain a discussion of some of the similarities and differences among the various types of for profit and nonprofit entities, in the areas of formation, limitation of liability, ownership, governance, transferability of interests and dissolution. The tax aspects of for profit and nonprofit entities will be covered by other panelists.

B. For-Profit Entities. One of the first decisions that a new business owner must make is to determine the appropriate legal form of the business entity. A for profit business will generally take one of the following forms: sole proprietorship, corporation, general partnership, limited partnership, limited liability partnership or limited liability company.

1. Sole Proprietorships. A sole proprietorship is a business which is owned by one (and only one) person. The sole proprietorship is a common form of business organization for small businesses because of its ease of formation. To establish a sole proprietorship, the owner need only obtain whatever licenses may be necessary for the particular business. No statutory filings are required to form a sole proprietorship.

A sole proprietorship is not recognized as a legal entity that is separate and distinct from the owner. Consequently, the owner is personally liable for all of the debts, liabilities and obligations of the sole proprietorship. Since a sole proprietorship is owned by one individual, the owner also controls all aspects of the business.

2. Corporations. Unlike the sole proprietorship, a corporation is a distinct legal entity which is separate from the persons who own it. Business corporations are governed by the Hawaii Business Corporation Act ("HBCA"), Chapter 414, Hawaii Revised Statutes ("HRS"). A corporation comes into existence in the State of Hawaii upon the delivery and filing of its articles of incorporation with the Director of the Department of Commerce and Consumer Affairs ("DCCA").

The bylaws of a corporation are the rules and regulations that govern the corporation's internal affairs and the rights and powers of its directors, officers and shareholders. The initial bylaws are adopted by the corporation's board of directors. The bylaws may contain any provisions for the regulation and management of the corporation not inconsistent with law or the articles of incorporation.

A share of the capital stock of a corporation is the interest or right which the owner has in the management of the corporation, in its surplus profits and, upon dissolution, in all of its remaining assets after payment of its debts. The HBCA grants a corporation the power to create and issue the number of shares stated in its articles of incorporation, which shares may be divided into one or more classes. The shares of any preferred or special class may be further divided and issued in series.

The HBCA gives the board of directors the power and authority to issue the corporation's stock. Consequently, it is left to the board of directors to determine that the consideration to be received for a corporation's shares is adequate. This determination by the board of directors is conclusive insofar as the adequacy of consideration for the issuance of shares relates to whether the shares are validly issued, fully paid and nonassessable.

Management of a corporation is not carried out by, but rather under the direction of, the board of directors. The board of directors is elected by the shareholders of the corporation and sets the policies of the corporation. All major decisions should be approved by the board of directors and properly documented. In addition, the board should document all decisions which could be the subject of future controversy, result in adverse tax consequences if not properly characterized, or represent major policy decisions.

The directors elect the officers to run the day-to-day operations of the corporation. The authority and duties of the officers and agents of the corporation are as provided in the bylaws and as may be determined by resolution of the board of directors.

Shareholders, directors and officers are generally not liable for the debts and obligations of a corporation. The corporation is treated as a separate legal entity, and therefore, bears responsibility for its own debts and obligations. Notwithstanding the foregoing, an officer or director may be held personally liable if he or she breaches a duty owed to the corporation. Additionally, shareholders may be held liable for debts or obligations if a court "pierces the corporate veil" and disregards the separate nature of the corporate entity. Common factors contributing to piercing the corporate veil include (i) fraud or other wrongdoing by the shareholders; (ii) inadequate capitalization of the corporation; (iii) failure to adhere to corporate formalities; and (iv) commingling of corporate and personal assets. As such, proper incorporation of the business is important and all corporate formalities should be followed, including the election of directors and officers, preparation of separate corporate accounting records, and maintenance proper minutes of meetings and other corporate records.

Corporations have a centralized form of management where the shareholders generally do not have any direct control over the business of the corporation. Rather, the board implements corporate policies and authorizes or ratifies corporate action, while the officers conduct the day-to-day business of the corporation. This structure may be beneficial when active participation in the business by certain parties is not practicable or agreeable. If, however, the parties desire to maintain some control or to have input into certain decisions, provisions can be made in the articles of incorporation, the bylaws or a shareholders agreement requiring the vote of the shareholders in specific circumstances.

The corporate business continues in perpetuity even after one or more of the shareholders dies. This allows for an easier transition in the event of a change in ownership.

Shares in a corporation are freely transferable, subject only to limitations imposed by the securities laws. If so desired, shareholders may also place restrictions on the transfer of corporate stock through various agreements. This is more typical in corporations where there are only a small number of shareholders and these shareholders either participate in the operations of the corporation or want to protect themselves from any major changes in the control and operation of the corporation.

Corporations may adjust the ownership rights of their shareholders by having different classes of common and preferred stock, including voting and nonvoting, dividend preferences and liquidation preferences. Debt instruments may be convertible to stock, and one type of stock may be convertible to another.

The relevant provisions for dissolution of a corporation are set forth in HRS §§ 414-381 through 414-415. A corporation may be voluntarily dissolved by the incorporators, by consent of the shareholders or by act of the corporation. Voluntary dissolutions are carried out primarily for business reasons, such as the termination of the corporation's business, the reorganization into another business entity form or the resolution of shareholder disputes. Once appropriately authorized and approved by the board of directors and shareholders, the corporation may dissolve by filing articles of dissolution with the DCCA. The corporation is dissolved upon the effective date of its articles of dissolution, unless a delayed effective time and date is specified in the articles.

A corporation is administratively dissolved upon the expiration of the period of duration stated in the articles of incorporation. The Director of the DCCA may commence proceedings to administratively dissolve a corporation if the corporation fails to (i) pay any fees prescribed by law; (ii) file its annual report for a period of two consecutive years; (iii) appoint and maintain an agent for service of process as required; or (iv) file a statement of a change in the name or business address of the agent as required by law. HRS §414-401. If the corporation does not correct each ground for dissolution within 60 days after the DCCA mails notice to the corporation of such deficiencies, the corporation will be dissolved by the Director.

Additionally, a corporation may be involuntarily dissolved by judicial action if:

(i) In a proceeding by the attorney general, it is established that the corporation obtained its articles of incorporation through fraud, or the corporation has continued to exceed or abuse its legal authority;

(ii) In a proceeding by a shareholder, it is established that the corporation is being irreparably injured due to the directors being deadlocked in the management of the corporate affairs; the directors or those in control have acted, are acting or will act in an illegal, oppressive or fraudulent manner; the shareholders are deadlocked in voting power and have failed for two years to elect successors to directors whose terms have expired; or the corporate assets are being misapplied or wasted;

(iii) In a proceeding by a creditor, it is established that the creditor's claim has been reduced to judgment, the execution on the judgment returned unsatisfied, and the corporation is insolvent; or the corporation has admitted in writing that the creditor's claim is due and owing and the corporation is insolvent; or

(iv) In a proceeding by the corporation to have its voluntary dissolution continued under court supervision.

3. General Partnerships and Limited Partnerships. Hawaii law recognizes four types of partnerships: general partnerships, limited partnerships, limited liability partnerships and limited liability limited partnerships. A partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit . . . ." HRS §425-101.

a. General Partnerships. General partnerships are governed by the Hawaii Uniform Partnership Act, HRS Chapter 425. A partnership is formed upon the association of two or more persons to carry on as co-owners a business for profit, whether or not the persons intended to form a partnership. HRS §425-109(a). Accordingly, no filings or written agreements are legally required to form a general partnership.

HRS § 425-109(c) sets forth the following rules to help determine whether a partnership is formed:

(i) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property.

(ii) The sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived.

(iii) A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment:

(a) Of a debt by installments or otherwise;

(b) For services as an independent contractor or of wages or other compensation to an employee;

(c) Of rent;

(d) Of an annuity or other retirement or health benefit to a beneficiary, representative, or designee of a deceased or retired partner;

(e) Of interest or other charge on a loan, even if the amount of payment varies with the profits of the business, including a direct or indirect present or future ownership of the collateral, or rights to income, proceeds, or increase in value derived from the collateral; or

(f) For the sale of the goodwill of a business or other property by installments or otherwise.

While no formalities are required to form a general partnership, the partnership is required to file a registration statement with the DCCA within 30 days after the partnership is formed.

General partnerships are easier and less costly to form due to the lack of statutory requirements. General partnerships are also easier to operate as they have minimal operating and reporting requirements. Each partner also has the ability to unilaterally bind the partnership.

The major disadvantage of general partnerships is the joint and several liability of the partners. A general partner is jointly and severally liable with all other general partners for the debts and obligations incurred by or on behalf of the partnership after the partner's admission to the partnership. HRS §425-117(a) and (b). Once a general partner has dissociated itself from the partnership, the dissociated partner is not liable for a partnership obligation incurred after dissociation (except in the circumstances described below), however, the partner remains liable for any partnership obligations incurred before dissociation. HRS §425-135(a). A dissociated partner may continue to be liable as a partner if the partnership is not dissolved and if the partnership enters into a transaction within two years after the partner's dissociation, where the other party reasonably believed that the dissociated was still a partner and did not have notice of the partner's dissociation. HRS §425-135(b). A dissociated partner may be released from liability for partnership obligations if (i) a partnership creditor and the remaining partners agree to release the dissociated partner, or (ii) a partnership creditor has notice of the partner's dissociation and agrees to a material change in the nature of time of payment of a partnership obligation. HRS §425-135(c) and (d).

The relevant provisions for dissolution and winding up a partnership are set forth in HRS Sections 425-138 through 425-144. Section 425-138 specifies the following events which result in the dissolution of the partnership:

(i) In a partnership at will, the partnership's having notice from a partner, other than a partner who is dissociated under HRS §§ 425-130(2) to (10), of that partner's express will to withdraw as a partner, or on a later date specified by the partner;

(ii) In a partnership for a definite term or particular undertaking:

(a) Within ninety days after a partner's dissociation by death or otherwise under HRS § 425-130(6) to (10) or wrongful dissociation under HRS § 425-131(b), the express will of at least half of the remaining partners to wind up the partnership business, for which purpose a partner's rightful dissociation pursuant to HRS § 425-131(b)(2) constitutes the expression of that partner's will to wind up the partnership business;

(b) The express will of all of the partners to wind up the partnership business; or

(c) The expiration of the term or the completion of the undertaking.

(iii) An event agreed to in the partnership agreement resulting in the winding up of the partnership business;

(iv) An event that makes it unlawful for all or substantially all of the business of the partnership to be continued;

(v) On application by a partner, a judicial determination that:

(a) The economic purpose of the partnership is likely to be unreasonably frustrated;

(b) Another partner has engaged in conduct relating to the partnership business which makes it not reasonably practicable to carry on the business in partnership with that partner; or

(c) It is not otherwise reasonably practicable to carry on the partnership business in conformity with the partnership agreement.

(vi) On application by a transferee of a partner's transferable interest, a judicial determination that is equitable to wind up the partnership business:

(a) After the expiration of the term or completion of the undertaking, if the partnership was for a definite term or particular undertaking at the time of the transfer or entry of the charging order that gave rise to the transfer; or

(b) At any time, if the partnership was a partnership at will at the time of the transfer or entry of the charging order that gave rise to the transfer.

Additionally, the court has the power to dissolve the partnership if it finds that a partner's conduct in matters relating to the partnership business makes it not reasonably practicable for the other partners to carry on the partnership business with him. <u>Lau v. Wong</u>, 1 Haw. App. 217, 616 P.2d 1031 (1980).

Upon dissolution, the partnership still exists, but continues only until the winding up of partnership affairs is completed. HRS §425-139.

b. <u>Limited Partnerships</u>. Limited partnerships are governed by the Hawaii Uniform Limited Partnership Act, HRS Chapter 425E. Unlike general partnerships, limited partnerships are statutory entities. Consequently, a limited partnership is not formed until a certificate of limited partnership is filed with the Director of the DCCA.

The advantages of a limited partnership include: (i) limited liability of the limited partners; (ii) flexibility with respect to allocation of profits and losses; (iii) generally tax free contribution of assets relating to formation of the partnership; (iv) easy transferability of limited partnership interests within the parameters of the partnership agreement; (v) transfer of partnership interest does not dissolve the partnership; (vi) partnership is not taxed at the entity level; (vii) death of a limited partner does not require dissolution of the partnership; and (viii) centralized management in the general partners.

The disadvantages of a limited partnership include: (i) general partners are jointly liable for all obligations of the limited partnership and jointly and severally liable for the wrongful acts of the other partners; (ii) limitation on limited partners' participation in the management of the business; (iii) limited partnership's potential for reclassification for taxation as a C corporation under federal tax laws; (iv) limited partnership interests are generally securities and thus are subject to the requirements of state and federal securities law; and (v) more rigid compliance with state statutory requirements for formation and operation.

Except as described below, a limited partner is not liable for the obligations of a limited partnership unless the limited partner is also a general partner. HRS §425E-303. While limited partnerships provide liability protection for the limited partner(s), the general partner(s) are still personally liable for the debts and obligations of the limited partnership. Moreover, the advantages of a limited partnership can also be found in a limited liability company while permitting participation in management by all partners. Accordingly, except for limited uses such as family limited partnerships formed for estate planning purposes, most entities which would have in the past been formed as limited partnerships are now being formed as limited liability companies.

The relevant provisions for dissolution and winding up of a limited partnership are set forth in HRS §§ 425D-801 through 425D-804. HRS § 425D-801 specifies the following events which result in the dissolution and winding up of the limited partnership:

(i) Expiration of the term specified in the certificate of limited partnership;

(ii) Upon the happening of an event specified in the partnership agreement;

(iii) Written consent of all partners; or

(iv) Withdrawal of a general partner unless (i) there is at least one other general partner and the partnership agreement permits the business to be carried on by the remaining general partner and that partner does so or (ii) within 90 days after the withdrawal, all partners agree in writing to continue the business and appoint one or more additional general partners, if necessary.

HRS §425D-802 also provides that on application by or for a partner, the court of the circuit in which the limited partnership’s principal place of business is located may decree the partnership dissolved whenever it is not reasonably practicable to carry on the business in conformity with the partnership agreement.

Upon dissolution, the partners may wind up the limited partnership's affairs or, upon application by any partner or any partner's legal representative or agent, the court may wind up the limited partnership's affairs. HRS §425D-803.

c. Limited Liability Partnerships. A general partnership may become a limited liability partnership ("LLP") by filing a Registration Statement for Partnership and a Statement of Qualification. HRS §425-152. Under Hawaii law, an LLP continues to be the same entity that existed before the filing of the Statement of Qualification. HRS §425-108(b). This is also true for federal and state income tax purposes, so that a general partnership converting to an LLP has not changed at all (e.g., it maintains the same federal ID number, files the same tax forms and has not undergone a technical termination).

An LLP must append the words "Limited Liability Partnership" or "Registered Limited Liability Partnership" or the letters "LLP" or "RLLP" to its name, even if it is a converting general partnership. HRS §425-151. There are separate registration, annual report and withdrawal forms for foreign limited liability partnerships wishing to do business in Hawaii.

The only significant distinction between an LLP and a general partnership is the extent of the personal liability of the partners. All partners of a general partnership are liable jointly and severally for all obligations of the partnership. HRS §425-117(a). A partner of an LLP, however, is not personally liable for any obligations of the LLP solely by reason of being a partner. HRS §425-117(c). Accordingly, as between a general partnership and an LLP, there is no question that the LLP is the preferred form.

d. Limited Liability Limited Partnerships. Similar to the relationship between a general partnership and an LLP, a limited liability limited partnership ("LLLP") is a limited partnership where the general partner is not personally liable for any obligations of the LLP solely by reason of being a general partner. HRS §425E-404(c). An LLLP must append the words "Limited Liability Limited Partnership" or the letters "LLLP" to its name. HRS §425E-108.

4. Limited Liability Companies. A limited liability company ("LLC") is created pursuant to the Hawaii Limited Liability Act, HRS Chapter 428 (the "LLC Act"). The owners of an LLC are referred to as "members" and have rights which are in some ways similar to those of corporate shareholders and in some ways similar to partners. Generally, the members of an LLC are not personally liable for the debts and obligations of the LLC, just as corporate stockholders are not personally liable for the debts and obligations of the corporation. At the same time, under the "check the box" regulations, an LLC will usually be taxed as a partnership (*i.e.*, flow-through tax treatment). Thus, the LLC may offer the best of both worlds: limited liability similar to a corporation and the flexibility and tax advantages of a partnership.

a. Formation. Since an LLC is defined and created by statute, it can only be created by filing articles of organization with the DCCA. An LLC's articles of organization are similar to a corporation's articles of incorporation. In addition to basic identifying information, the articles of organization must set forth whether the duration of the LLC is at will or for a specified term, whether the LLC is to be managed by managers or its members, and whether the members of the LLC are to be liable for its debts and obligations.

The members of an LLC may, but are not required to, adopt an operating agreement. The operating agreement is an agreement among the members setting forth the relationship among the members, the managers and the LLC.

Although an operating agreement is not legally required, it is critical for documenting the respective rights and obligations of the members and managers. Without an operating agreement, the members will become subject to the default rules of the LLC Act, which may result in unintended consequences. For example, HRS §428-404(a)(2) provides that except for certain actions which require the consent of all members, any matter relating to the business of the LLC may be decided by a majority of the members. While this provision may be acceptable for an LLC whose members have equal ownership interests, it would not be acceptable for an LLC whose members have different ownership interests. Accordingly, it is important that the members review the default provisions of the LLC Act carefully and decide which ones must be negated by specific provisions in the operating agreement.

An operating agreement should at the minimum address the following matters:

(i) The name of the LLC;

(ii) The purpose or business of the LLC;

(iii) The amount and timing of the initial capital contributions of the members;

(iv) Whether additional capital contributions are permitted or required;

(v) The effect of a member failing to make any required capital contributions;

(vi) The extent of the interest in the LLC held by each member;

(vii) The allocation of profits and losses;

(viii) When and how distributions to the members will be determined;

(ix) The transfer of membership interests, including limitations, rights of first refusal and repurchase rights;

(x) The addition of new members and the dissociation of existing members;

(xi) The compensation of the members, if any;

(xii) The management of the LLC, including the management rights of the members (or managers if the LLC is a manager-managed LLC) and provisions for notices and meetings;

(xiii) Any limitations on the authority of the members;

(xiv) The maintenance of the books and records;

(xv) Conflicts of interest and competing activities of the members;

(xvi) Events of dissolution and termination of the LLC; and

(xvii) Amendment of the operating agreement.

b. Non-waivable provisions. The LLC Act is commonly referred to as a "default statute," due to the fact that the majority of the provisions of the LLC Act may be modified or eliminated in an operating agreement. There are, however, certain matters that may not be varied by the operating agreement. Specifically, HRS §428-103(b) provides that an operating agreement may not:

(i) Unreasonably restrict a right to information or access to books and records under HRS §428-408;

(ii) Eliminate the duty of loyalty under HRS §§428-409(b) or 428-603(b)(3), but the operating agreement may:

(a) Identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; or

(b) Specify the number or percentage of members or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

(iii) Unreasonably reduce the duty of care under HRS §§428-409(c) or 428-603(b)(3);

(iv) Eliminate the obligation of good faith and fair dealing under HRS §428-409(d), but the operating agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable;

(v) Vary the right to expel a member in an event specified in HRS §428-601(5);

(vi) Vary the requirement to wind up the limited liability company’s business in a case specified in HRS §428-801(3) or 428-801(4); or

(vii) Restrict rights of third parties under the Hawaii Uniform Limited Liability Company Act, other than managers, members or their transferees.

c. Management. An LLC may be managed by its members (in what is referred to as a member-managed LLC) or by managers who may, but need not be members (in what is referred to as a manager-managed LLC). In a member-managed LLC, each member has the right to manage the LLC's business and the power to bind the LLC. This is similar to a partnership, where any partner can bind the partnership contractually. In a manager-managed LLC, the managers have the right to manage the LLC's business and the power to bind the LLC. This is similar to a corporation, where the officers normally have the power to bind the corporation.

An LLC may also appoint officers to conduct the day to day business of the LLC. Officers are not, however, provided for in the LLC Act. Consequently, if an LLC chooses to appoint officers, the operating agreement must clearly set forth their duties, responsibilities and authority.

d. Relationship of Members to Entity. A member's contribution to the capital of an LLC may be in cash, property (real or personal, including intangibles), or in the form of services. There is no minimum amount of capital required to become a member, and the voting power of a member is not required to be proportionate to the member's capital contribution. A member's obligation to contribute capital is not excused by the member's death; it becomes an obligation of his estate. Generally, creditors of the entity can enforce the obligations of the members to make capital contributions, but only to the extent that the entity itself could enforce such obligations.

Although the default provisions of the LLC Act provide for equal distributions, virtually any system or formula can be agreed upon. For tax purposes, the distribution system may need to have some economic basis, but as a matter of state law the members can agree on any method of distribution. To the extent that distributions are made while the entity is insolvent, or to the extent that distributions render the entity insolvent, creditors will generally have the power to force members to disgorge those distributions.

The default provisions of the LLC Act give each member one vote (regardless of the size of their respective capital interests), but again this may be changed in the operating agreement. Voting power may be made proportional to ownership or completely unconnected to ownership. With certain exceptions, most decisions require a simple majority vote (but this may also be changed).

Members who perform services for the entity are not automatically entitled to wages, salaries, or other compensation, although compensation can be agreed upon. Members who advance funds for legitimate expenses of the entity are entitled to reimbursement from the entity.

e. Relationship of Third Parties to Entity. Generally, a third party dealing with an LLC will want to ascertain whether the LLC is member-managed or manager-managed, as this will determine who is empowered to act on behalf of the entity.

In a manager-managed LLC, only the named managers have the power to bind the LLC. Generally, any one manager can bind the LLC, even if there are multiple managers. Managers are normally presumed to have authority to act on behalf of the LLC. However, if the third party dealing with a manager knew or had notice that the manager lacked authority to do a particular act, then the manager does not bind the LLC by doing so. In a member-managed LLC, any member has the power to bind the LLC in carrying on business in the ordinary course or business of the type carried on by the LLC. If the LLC wishes to place specific limitations on the authority of managers or members, the LLC may want to consider stating those limitations in its articles of organization (which is a public-record document).

Transferees of members, and creditors who effectively become transferees through judicial remedies, do not automatically become members, but succeed to the member's right to receive distributions, and to whatever right the member had to obtain a dissolution. This means that the transferee or creditor shares in any distributions (to the extent that the member would have), but has no voting power or management rights. In general, a transferee can become a member only with the consent of all other members, or upon satisfaction of the requirements of the operating agreement.

f. <u>Dissociation</u>. Any member of an LLC can dissociate himself or herself voluntarily at any time. However, dissociation which is contrary to the operating agreement is wrongful dissociation, for which the LLC may be entitled to remedies. The operating agreement may also specify situations in which a member may be involuntarily dissociated, *i.e.* expelled. Dissociation can also be judicially ordered for certain wrongful acts, such as a willful breach of a member's duties.

A member who wrongfully dissociates is liable to the LLC and to the other members for any damages caused by the dissociation. These damages may be offset against any distributions otherwise due to the member.

When a member dissociates, rightfully or wrongfully, the member's right to participate in management ceases. In an at-will LLC, the member is entitled to have his interest redeemed by the LLC at the time of dissociation. In an LLC for a fixed term, the member effectively has the status of a transferee (*i.e.*, he shares in distributions but has no vote or management rights) until the end of the term, at which point his interest is redeemed in the final dissolution. In either case, the price paid to the member for his interest can either be fixed by a formula or method set forth in the operating agreement, or be set at "fair value" by a court. Any damages for wrongful dissociation would be deducted from amounts otherwise due to the member.

If the dissociation of a member does not result in the dissolution of the LLC, then the dissociated member may have continuing power to bind the LLC. For a period of two years after the dissociation, the dissociated member can still bind the LLC if the third party dealing with the dissociated member does not have notice of the dissociation and reasonably believes that the dissociated member is still a member. This two-year period can effectively be shortened to 90 days (but not entirely eliminated) by filing a statement of dissociation with DCCA, and thus making the dissociation a matter of public record.

g. Limitation of Liability. As originally enacted in 1996, the Hawaii LLC Act provided that where a party seeks to hold the members of an LLC personally liable for the obligations of the LLC, the court shall apply the corporate law doctrine of "piercing the corporate veil." This doctrine of "piercing the corporate veil" allows a court to disregard the corporate legal entity and to treat the corporation and the shareholders as identical where recognition of the corporate entity would result in injustice or inequity, or where there is evidence which shows that the corporate entity has been used as a guise to perpetrate fraud.

In determining whether to disregard a corporate entity, a court will examine several factors, including: (i) whether the corporation was adequately capitalized; (ii) whether there is any co-mingling of the assets of the corporation and the shareholders; and (iii) whether the corporation observes basic corporate formalities, such as maintaining separate books and records, adopting bylaws and holding board and shareholder meetings. No single factor is conclusive in determining whether the corporate entity will be disregarded. The court will make that determination in order to prevent an inequitable result, taking into consideration the facts and circumstances of the specific case.

In 1999, the legislature repealed the provision of the LLC Act which required courts to apply the corporate case law on "piercing the corporate veil" to LLCs. The committee report indicates that the repeal of this section was a "housekeeping measure" and was "not intended to affect underlying individual rights to pierce the corporate veil." At this point, it is unclear whether "piercing the veil" is any more difficult in an LLC than a corporation.

5. Summary of Advantages and Disadvantages. The following is a summary of some of the advantages and disadvantages of the various for profit business entities.

a. Limited Liability Companies.

(i) Advantages:

(a) Limited liability of owners;

(b) Single-level taxation;

(c) Greater flexibility with regard to the business operations and arrangements and ability to specially allocate profits and losses;

(d) May have more than one class of membership interests;

(e) Can contribute appreciated assets to the LLC in exchange for membership interests without gain on the exchange;

(f) Liquidating and nonliquidating distributions of appreciated property are generally received without gain.

(ii) Disadvantages:

(a) Cost of drafting operating agreement can be higher than the governing documents of other business entities;

(b) LLC can terminate upon the death of a member;

(c) LLC members can force a buy out of interest in an at-will LLC;

(d) Little case law and rulings on LLCs in comparison to other types of business entities;

b. Limited Liability Partnerships.

(i) Advantages:

(a) Limited liability of partners;

(b) Single-level taxation;

(c) Less formation costs and less operating and reporting requirements than most other types business entities;

(d) Greater flexibility with regard to the business agreement and distributions among the owners;

(ii) Disadvantages:

(a) Partnership can terminate upon the death of a partner;

(b) Cost of drafting partnership agreement can be higher than the governing documents of other business entities;

(c) Little case law and rulings on LLPs in comparison to other types of business entities

(d) Limitations of liability treatment varies from state to state.

c. C Corporations.

(i) Advantages:

(a) Limited liability of owners;

(b) Continuity of business after one or more of the shareholders dies;

(c) Centralized and hierarchical management;

(d) Transferability of ownership interest generally more flexible than other business entities;

(e) Ability to have various classes of stock.

(ii) Disadvantages:

(a) Double taxation;

(b) Corporate formalities must be followed;

(c) Higher tax preparation costs.

d. S Corporations.

(i) Advantages:

(a) Single-level taxation;

(b) Limited liability of owners;

(c) Continuity of business after one or more of the shareholders dies;

(d) Self-employment and Medicare tax do not apply to shareholder's income distribution, provided that shareholder receives reasonable compensation for services rendered'

(e) Centralized and hierarchical management;

(ii) Disadvantages:

(a) Corporate formalities must be followed;

(b) Number of shareholders is limited to 75;

(c) Permitted shareholders are limited to individuals, certain trusts and another S corporation under certain circumstances;

(d) Only one class of stock allowed;

(e) Tax allocation and distribution rules are fairly rigid;

(f) Technical tax requirements must be observed.

e. <u>General Partnerships</u>.

(i) Advantages:

(a) Single-level taxation;

(b) Less formation costs and less operating and reporting requirements than most other types business entities;

(c) Greater flexibility with regard to the business agreement and distributions among the owners;

(ii) Disadvantages:

(a) Partners have joint and several liability;

(b) Partnership can terminate upon the death of a partner;

(c) Cost of drafting partnership agreement can be higher than the governing documents of other business entities.

f. Limited Partnerships.

(i) Advantages:

(a) Limited liability for limited partners;

(b) Single-level taxation;

(c) Less formation costs and less operating and reporting requirements than most other types business entities;

(d) Greater flexibility with regard to the business agreement and distributions among the owners;

(e) Easy transferability of limited partnership interests;

(f) Transfer of partnership interest does not dissolve the partnership;

(g) Death of a limited partner does not require dissolution of the partnership;

(h) Centralized management in the general partners.

(ii) Disadvantages:

(a) Personal liability of the general partner(s);

(b) Cost of drafting partnership agreement can be higher than the governing documents of other business entities;

(c) Limitation on limited partners' participation in the management of the business;

(d) Limited partnership interests are generally securities and thus are subject to the requirements of state and federal securities law;

(e) More rigid compliance with state statutory requirements for formation and operation.

g. Sole Proprietorships.

(i) Advantages:

(a) Easy to form and maintain with minimal costs;

(b) Few legal restrictions;

(c) Flexible management;

(d) Maximum control over operations by owner;

(e) Simple tax preparation;

(ii) Disadvantages:

(a) Personal liability of owner;

(b) One owner only;

(c) More difficult to transfer the business;

(d) Lack of business continuity at owner death.

C. Nonprofit and Tax Exempt Organizations.

The terms "nonprofit organization" and "tax-exempt" organization are often used loosely and interchangeably. In reality, however, they have very different meanings which can have a dramatic impact on the rights and obligations of the organization. In summary, a nonprofit organization is one that is formed to benefit persons other than the organizers and managers. A nonprofit organization is generally formed pursuant to state law. A discussion of the more common forms of nonprofit organizations are discussed below. A tax-exempt organization, in addition to being a nonprofit organization, is recognized by the Internal Revenue Service as being exempt from income tax, except on unrelated business income.

While nonprofit organizations may also be tax-exempt organizations, they do not automatically become so. In order to be recognized as a tax-exempt organization, the organization generally must first obtain a determination from the Internal Revenue Service.

1. Nonprofit Corporations. The majority of all exempt organizations are formed as nonprofit corporations. The primary advantages of incorporation include (i) protection of individual members against personal liability; (ii) a framework for the continuity of the organization; (iii) the right to hold title to property; and (iv) a statutory structure for administration and decision making over the corporation's affairs.

A corporation's articles of incorporation, together with the provisions of the Hawaii Nonprofit Corporation Act (the "Nonprofit Corporation Act"), HRS Chapter 414D, govern the formation and operation of a nonprofit corporation in the State of Hawaii. The articles of incorporation serve as a contract between (i) the state and the corporation; (ii) the corporation and its members (if any); and (iii) the respective members of the corporation. Accordingly, the contents of the articles of incorporation will evidence the agreement by which these parties consent to be bound.

A corporation comes into existence in the State of Hawaii upon the delivery and filing of its articles of incorporation with the Director of the Department of Commerce and Consumer Affairs ("DCCA"). The Nonprofit Corporation Act requires the following information to be contained in the articles of incorporation: (i) the name of the corporation; (ii) the street address of the corporation's initial office and the name of its initial registered agent; (iii) the name and address of each incorporator; (iv) whether or not the corporation will have members; and (v) provisions regarding the distribution of assets upon dissolution. The articles of incorporation may also contain the purpose or purposes for which the corporation is organized, the names and addresses of the initial directors, and other information not inconsistent with law regarding the management and regulation of the affairs of the corporation, the powers of the corporation, and the rights of the members.

The articles of corporation are also permitted to contain provisions eliminating or limiting the personal liability of a director to the corporation or members of the corporation for monetary damages for breach of the director's duties to the corporation and its members, except that the liability of a director may not be eliminated or limited for: (i) a breach of the director's duty of loyalty; (ii) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) any transaction from which a director derived an improper personal economic benefit; or (iv) director conflicts of interest, approval of loans to directors and officers, and approval of improper distributions.

After the Nonprofit Corporation Act and the articles of incorporation, the bylaws are the third set of governing regulations of a nonprofit corporation. The bylaws of a nonprofit corporation are the rules and regulations which govern the conduct of its affairs and the rights and powers of its directors, officers and members. The initial bylaws of a corporation are adopted by the board of directors or the incorporators and may contain any provisions for the regulation and management of the affairs of the corporation not inconsistent with law or the articles of incorporation.

Bylaws are generally drafted with a view to assisting the officers and director in administering the affairs of the corporation in compliance with the requisite corporate formalities. Consequently, a corporation's bylaws will typically include provisions regulating the number and qualifications of officers and directors, the election and removal of officers and directors, the call and notice of meetings, quorum and voting requirements, and the conduct of meetings.

The Nonprofit Corporation Act provides default rules for the administration of the corporation's affairs, many of which may be overridden by contrary provisions contained in the articles of incorporation or bylaws. Accordingly, quorum requirements and other provisions contained in the bylaws may be tailored to meet the corporation's specific needs.

The bylaws of a nonprofit corporation should also address the rights of the members, the duties of officers, directors and committees of the board, and the procedures for amendment of the bylaws.

A nonprofit corporation's activities and operations are managed by its board of directors. Under Hawaii law, a nonprofit corporation must have a minimum of three directors. The directors are elected and removed by the members, if any, or in the manner provided in the articles of incorporation or the bylaws.

The board of directors may delegate some of their authority to one or more committees appointed by the board. The members of the board committees must be directors of the corporation. A committee of the board may, to the extent so delegated, may exercise all authority of the board, except that a committee may not: (i) authorize distributions; (ii) approve or recommend to members dissolution, merger or the sale, pledge or transfer of all or substantially all of the corporation's assets; (iii) elect, appoint or remove directors or fill vacancies on the board or on any of its committees; or (iv) adopt, amend or repeal the articles of incorporation or bylaws.

A corporation's bylaws will describe the officers of the corporation. The articles of incorporation or the bylaws may also prescribe the method for election of the officers. In the absence of any such provision, the officers will be elected by the board of directors.

A nonprofit corporation may have one or more classes of members or it may have no members. The decision whether or not to have members depends on the activities and operations of the corporation. If a corporation has members, the members are generally given the right to elect the board of directors and to vote on other important decisions. The members' right to vote, however, may be limited, expanded or denied as provided in the articles of incorporation or the bylaws.

The criteria or procedures for admission of members should be contained in the corporation's articles of incorporation or bylaws. The articles of incorporation or bylaws must also contain a procedure for the termination, suspension and removal of members.

All members are presumed to have the same rights and obligations with respect to voting, dissolution, redemption, transfer and other matters unless the articles of incorporation or bylaws establish classes of membership with different rights or obligations. This allows the corporation to have great flexibility in setting the rights of the members. The corporation may, for example, establish different rights and obligations relating to dues, assessments and voting. The distinctions may be based on seniority, activity and other factors that the corporation deems important. Any limitation, enlargement or denial of the voting rights of the members must be specified in the articles of incorporation.

A member of the corporation is not personally liable for the acts, debts, liabilities or obligations of the corporation. Members thus have limited liability, except if there are facts which support a piercing of the corporate veil or a legally enforceable obligation of the member to the corporation.

A member may be expelled or suspended from the corporation, but only pursuant to a procedure that is fair and reasonable and carried out in good faith. Under the Nonprofit Corporation Act, a procedure is deemed to be fair and reasonable if (i) the procedure is contained in the articles of incorporation or bylaws; (ii) requires not less than fifteen days written notice of the expulsion, suspension or termination; (iii) the notice contains the reasons for the expulsion, suspension or termination; and (iv) the member is given an opportunity to be heard at least five days before the effective date.

Although the rights of members are similar to those of shareholders in a for profit corporation, the members have no economic interest in the nonprofit corporation. Accordingly, there is no “ownership” of the nonprofit corporation as there is in a for profit corporation.

The day to day operations of a nonprofit corporation are carried out by its paid staff, under the direction of an executive director. The bylaws of the corporation should specify the duties and powers of the executive director. The executive director is not an officer of the corporation, unless the executive director is specifically given the title of an officer.

The relevant provisions for dissolution of a nonprofit corporation are set forth in HRS §§ 414D-241 through 414-256. Similar to a for profit corporation, a nonprofit corporation may be voluntarily dissolved by the incorporators or by act of the corporation. One significant difference in the dissolution process is that a nonprofit corporation which is a public benefit corporation (i.e., generally a corporation that is exempt under section 501(c)(3) of the Internal Revenue Code or that is organized for public or charitable purposes) is required to give the attorney general written notice that it intends to dissolve before it files articles of dissolution with the DCCA and may not transfer or convey any assets until 20 days after it has given the notice to the attorney general. After all of the assets have been transferred, the corporation is also required to provide the attorney general with a list showing to whom the assets were transferred.

A nonprofit corporation may also be administratively or judicially dissolved like for profit corporations.

Nonprofit corporations which are exempt under section 501(c)(3) of the Internal Revenue Code are required to distribute its assets upon dissolution to one or more organizations which are also exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code.

2. Unincorporated Associations. An unincorporated association is generally defined as a group of people joined together for a common, nonprofit purpose. Some older and more loosely structured organizations continue to exist today as unincorporated associations.

The primary advantage of an unincorporated association is its ease of formation. No statutory filings are required to form or maintain an unincorporated association.

While unincorporated organizations have existed for many years, general purpose unincorporated associations were only recently recognized as separate legal entities in Hawaii. In 1999, Hawaii adopted the Uniform Unincorporated Nonprofit Association Act, HRS Chapter 429 (the "Unincorporated Association Act"). The primary purpose of the Unincorporated Association Act is to clarify (i) the rights of an unincorporated association to hold real and personal property in its name; (ii) the ability of an unincorporated association to sue and be sued in its name; and (iii) the contract and tort liability of the members and officers of an unincorporated association. The Unincorporated Association Act does not, however, provide any guidance on the organization, governance and operations of an unincorporated association and the rights and responsibilities of its members.

The lack of statutory direction, coupled with the absence of Hawaii case law on unincorporated associations, makes the unincorporated association an undesirable form of legal entity for the majority of all nonprofit organizations. Any nonprofit organization that continues to exist as an unincorporated association should strongly consider converting to the corporate form.

3. Charitable Trusts. Charitable trusts are formed when a grantor conveys money or property to one or more trustees, to be disbursed as directed in a trust agreement. The beneficiaries of a charitable trust are unnamed members of a specified group of people.